Mr. Farrukh Habib

Assoc. Prof. Dr. Abu Umar Faruq Ahmad

ARE THE SUKUK DIFFERENT FROM CONVENTIONAL BONDS?

Sukuk: An Overview

The genesis of the Islamic capital market is indebted to the first issuance of financial certificate, which complied with the rules of Islamic law (Shari`ah), in 1990 by Shell MDS SdnBhd Malaysia amounting to RM125 million. Another issuance of RM600 million in 1991 by Sarawak Shell Bhd and RM300 million in 1993 by Petronas Dagangan Bhd further confirmed the market interest. Later issuances of the Islamic financial securities simply acted as catalyst in strengthening and further developing Islamic capital market. Therefore, it can be noted here that the main integral part of the Islamic capital markets is Islamic financial certificates.

What is Sukuk?

Sukuk is an Arabic word (صكوك), which is used for the Shari`ah-compliant financial securities. The very word Sukuk (صكوك) is the plural of the word 'Sakk' (صك), which literally means certificate, legal instrument or document representing financial obligation or right.

From technical perspectives, many definitions have been coined for Sukuk. Islamic finance experts still seem to tangle with issue of perfectly define the term 'Sukuk'. Nevertheless, some basic components in the definition have been agreed upon by almost all experts. For instance, Sukuk are financial certificates, structured within the permissible framework of Islamic law and associated with an underlying asset. On the other hand, it is observed that Sukuk still have not escaped from the context of conventional bond. The word 'bond' can easily be found in many definitions. For example: a digital dictionary defines Sukuk as:

"A financial certificate similar to a bond in Islam that complies with Islamic religious laws of Sharia".

While, QFINANCE Financial Dictionary states:

"In Islamic financing, the equivalent of a bond, which represents undivided shares in ownership of tangible assets. Under Islamic law it cannot earn interest"

It should be noticed that, although, Sukuk may be seen as alternatives to a conventional bond in practice; however, the underlying concept and structure of Sukuk is entirely different from conventional bonds.

The Sukuk as defined by AAOIFI are:

"Certificates of equal value representing undivided shares in ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity"

According to the Security Commission of Malaysia:

"Sukuk refers to certificates of equal value which evidence undivided ownership or investment in the assets using Shariah principles and concepts approved by the SAC".

From the above definitions, it can be inferred that Sukuk are commercial papers which represent undivided shares in ownership of or investment in the underlying assets, usufructs or services for the Sukuk holder or investor. It denotes the value of the underlying asset, which may or may not involve some portion of debt. According to the AAOIFI standards, in case the underlying asset carries some portion of debt, one third of the issue size should be composed of tangible asset in order to be floated in the secondary market.

The structure of a Sukuk should be based on the principles of exchange contracts elucidated in the Islamic law; meanwhile, the underlying asset should also comply with the rules of Shari`ah. On the other hand, it can be understood from the reciprocal analogy that Sukuk should not contain any elements prohibited by the Shair`ah.

Since, Sukuk are structured on Islamically permissible exchange contracts which transfer the ownership, it possesses to the feature of liquidity and tradability. Moreover, by virtue of the same characteristic, the Sukuk holder is entitled to the risk and return attributable to the underlying asset.

Sukuk versus Conventional Bonds

Conventional bond is fundamentally a loan contract; it does not give the investor a share of ownership in the asset, project or business. It is a contractual debt obligation on the bond issuer for the bond holder. The issuer is obliged to pay back the principal as well as the interest on that principal in the form of coupon payments. In contrast, Sukuk cannot be considered as loan contracts because of the irrevocable prohibition of riba in Islamic law, rather they need to be structured on any Shari`ah compliant exchange contracts, i.e. mudharabah, musharakah, ijarah, istisna', etc. It creates beneficial rights for the Sukuk holder in the underlying asset through undivided ownership over the asset. Hence, it represents participation and investment rights in a particular asset, project or business.

The investment criterion for a conventional bond simply follows only the local legislation. Conversely, the Sukuk should be designed within the permissible boundaries of Shari`ah. Furthermore, the returns of a bond are the interest or coupon payments on the principal amount, since the bond represents a share of debt. On the contrary, the returns for investors in Sukuk investments would be attributed to the underlying contract, share in the asset and the performance of that asset. The stream of cash-flows, which the investor receives, is not fixed. In addition, as the Sukuk holders possess the beneficial ownership rights in the asset through an SPV or SPC, the risk associated with that asset is also transferred to the SPV/SPC, which the Sukuk holders, ultimately have to bear.

The value of a bond at a particular point in time is based on the interest rate required in the market on that bond, which is called the bond's yield to maturity (YTM). In contrast, it is, in fact, the market value of the underlying asset, which determines the value of Sukuk.

Moreover, a bond can be tradable in a secondary market without being associated with the firm's assets. Although, Sukuk, by virtue of transfer of ownership of the asset, are also tradable in the secondary market, but might not be tradable in the secondary market when they represent more than one third of the debt to the Sukuk holder. In this case, instead, it can only be held until maturity or sold at par.

Islamic Legal Verdicts for the Issuance of Sukuk

In order for issuing Sukuk the very fundamental requirements are the compliance of Shari`ah principles which are inevitable for any other Shari`ah-compliant financial products. These include among others the prohibition of riba (charging and payment of interest), gharar (ambiguity in contracts), and maysir (games of chance) and laying emphasis on fair and ethical investments that contribute to the greater interest of society. In light of these key requirements Sukuk issuance should not simply be viewed as an alternative to conventional interest-based bonds and securities. Similarly, it will not merely seek to engineer financial products that imitate fixed-rate bonds and floating-rate notes as implicit in the Western world, rather to a certain extent to build up innovative types of assets that adhere to the Shari`ah. The spirit in the issuance of Sukuk lies in the concept of asset monetization (securitization) that is achieved through its process with the aim of transforming assets' future cash flow into present cash flow be they are issued on existing and specific assets that may become obtainable at a future date.

The Shari`ah Advisory Council (SAC) of Securities Commission (SC) of Malaysia deals with all the Islamic rulings regarding Islamic capital market (ICM) in Malaysia. Since its inception in 1996, SAC is responsible for Shari`ah compliance and governance in functional and operational issues at national level, which also has indirect important influence on the global Islamic capital market.

Some general key Shari`ah rulings issued by SAC can be confined in the following discussion:

Underlying Asset and Utilization of Proceeds

The underlying asset of Sukuk should comply with all the Shari`ah rulings regarding the asset of a contract. The asset should also be unencumbered; otherwise, the issuer should seek the permission of all the stakeholders in that asset before issuing Sukuk. In addition, the receivables which are established and certain can also become the underlying asset of Sukuk. Furthermore, the proceeds from the Sukuk issuance must be utilized in a Shari`ah compliant manner.

Asset Pricing

In order to support the notion of fair-pricing, SAC has also issued guidelines for pricing of the underlying asset of Sukuk. The SAC concludes that if an asset is sold at premium, the price of the asset should not exceed 1.51 times of its market value. On the other hand, if the asset is sold at a discount, the price of the asset should not be less than two third of the market value of that asset. In case, where the market value cannot be known, a fair and just price should be assigned to that asset.

Sale of Debt

As opposed to OIC Fiqh Academy resolutions and AAOIFI's standards, SAC has allowed the sale of debt in order to develop Islamic capital market.

Rebate

It is allowed to stipulate a provision of rebate in the primary legal document, but it should be noted that such provision cannot be a part of pricing section. By virtue of the introduction of rebate, BBA, Murabaha and Istisna Sukuk can utilize the variable rate mechanism benchmarked to the prevailing market rates.

Compensation

The SAC is also responsible to prescribe the rate of compensation from time to time. This is basically a penalty for the late payment. This compensation is for the delay of payment which cannot be compounded. However, it cannot be applied on the expected profit.

1. Research Officer, International Shari`ah Research Academy (ISRA) for Islamic Finance, Kuala Lumpur, Malaysia.
2. Senior Researcher, International Shari`ah Research Academy (ISRA) for Islamic Finance, Kuala Lumpur, Malaysia.